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UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW HAMPSHIRE

* * * * *

UNITED STATES OF AMERICA

v.

IMRAN ALRAI

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* 18-cr-192-01-JL

* December 12, 2019

* 1:30 p.m.

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TRANSCRIPT OF BENCH TRIAL
DAY NINE - AFTERNOON SESSION
BEFORE THE HONORABLE JOSEPH N. LAPLANTE

APPEARANCES:

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Matthew Hunter, AUSA
Cam T. Le, AUSA
U.S. Attorney's Office

For the Defendant:

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Also Present:

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Court Reporter:

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Official Court Reporter
United States District Court
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I N D E X

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1 P R O C E E D I N G S

2 THE COURT: Mr. Harrington, you may resume.

3 MR. HARRINGTON: Thank you, Judge.

4 THE COURT: Sir, you're still under oath.

5 THE WITNESS: Thank you, your Honor.

6 CONTINUED DIRECT EXAMINATION OF JASON SGRO

7 BY MR. HARRINGTON:

8 Q. Mr. Sgro, I think we left off when you were
9 talking about SIP.US, and you had gotten to the point I
10 think where you were talking about the flat fee for
11 management services and the contracts I think.

12 Do you recall?

13 A. Yes, I recall.

14 Q. Okay. So what is it that you had observed in
15 regard to that and in regard to the contracts that you
16 were referencing for the Judge?

17 A. Yes. Well, as I previously stated, the SIP.US
18 invoice to DTS, and eventually to the United Way, is
19 only a portion of the service provided -- or the
20 services required to build a Telephony system, and we
21 talked about, a little bit about networking and security
22 and phones and lines, and all of that stuff needs to be
23 provided.

24 Now, in Mr. Naviloff's review he points to the
25 IT managed services contract from 2013 and a line in

1 that contract saying there's a \$3,500 fee for services
2 like Telephony management.

3 Now, that at first glance looks to be
4 appropriate for covering the services that would be
5 required, the additional services for the phone system.
6 However, that contract predates the investment in
7 SIP.US. And what that means is that that contract was
8 intended in those Telephony management services, and the
9 subsequent security services and networking services
10 were all related to the legacy PBX-based on-prem phone
11 system.

12 Q. And that's the original one that was in place
13 when Mr. Alrai came to work at the United Way as you
14 understand it, correct?

15 A. As I understand it, that is correct.

16 And so that was for the management of that,
17 and so that could not possibly be for the management of
18 the SIP.US service because the SIP.US service didn't
19 exist when that contract was executed.

20 Q. And was there also a separate contract entered
21 into relative to Telephony services?

22 A. Yes, there is a Telephony services contract
23 between DTS and the United Way wherein they agreed on a
24 comprehensive price of \$70 per line.

25 And so during that migration SIP.US was used

1 as part of that service delivery by DTS, but that
2 contract rolled up those managed services, networking,
3 security, those sorts of things, to be included in that
4 \$70 line, and that's a fairly common practice.

5 Q. Okay. And with that in mind, I want to show
6 you a visual. And who made this visual?

7 A. I did.

8 Q. Okay. Can you explain what it's for in
9 relation to what you were just testifying about?

10 A. Yes. So much like the kind of error that is
11 made in analyzing the contracts for SIP.US, CloudConnect
12 is similarly analyzed.

13 Q. And so I want to just stop you briefly because
14 we're kind of segueing into a different topic --

15 A. Correct.

16 Q. -- from SIP.US to CloudConnect.

17 A. Yeah, we're now talking about -- this
18 references CloudConnect, the CloudConnect service.

19 Q. Okay. And if you could explain what that
20 means and this demonstrative aid for the Judge relative
21 to CloudConnect.

22 A. Yes. So before I explain that, I think it's
23 important to note the contracts, the way they were
24 analyzed in the RSM report suggests that the
25 CloudConnect services which were used as part of the

1 service delivery between DTS and the United Way, that
2 DTS didn't really add value to those and passed through
3 those costs at a considerable markup.

4 Q. So the idea and the testimony you heard was
5 that CloudConnect basically provided these services?

6 A. Right.

7 Q. They could have done so without DTS in the
8 middle and just dealt directly with the United Way?

9 A. That's correct.

10 Q. Okay. And you believe that's correct or
11 incorrect?

12 A. That's incorrect for a couple of reasons.

13 The first is that CloudConnect states on its
14 publicly available website that it doesn't deal directly
15 with end consumers. They always work in through a
16 third-party model. And the way the third-party reseller
17 model works is original providers, such as CloudConnect,
18 will keep their prices -- their price margins low enough
19 so that third party resellers can consume their
20 services, resell them at a profit, and build services
21 within those environments. I think it was stated before
22 by Mr. Meyer that it was a sandbox, if you will, and so
23 this diagram is a picture of what that sandbox might
24 look like.

25 And the contracts between DTS and the United

1 Way versus the contracts between CloudConnect and DTS
2 appear at first glance to be referencing similar type
3 items, that being cloud hosting of sorts, but not really
4 here. What you'll see is, in the bottom left-hand
5 corner, the CloudConnect hosting component is only one
6 part of that service delivery. Application development,
7 systems troubleshooting, patching, security, performance
8 monitoring, the building of VDI images, and that again
9 is virtual desktop image, and testing and regression
10 testing both of primary features and any kind of issues
11 that might arise through changes in the environment is
12 what regression means, all of that are examples, and
13 that's not a comprehensive list, are the things that go
14 into making this service useful.

15 And so what we need to understand here, what
16 I'll try to impress upon you, is that if you take the
17 CloudConnect service directly from CloudConnect, it's
18 fundamentally useless to an end consumer. It doesn't do
19 anything. It would be like buying a server box in the
20 cloud, right, somewhere else, and not having any
21 software and not having any network to get to it and not
22 having any user accounts or any of the things that are
23 listed on this diagram.

24 And so when you look at hosting as a
25 service -- infrastructure as a service, excuse me, and

1 hosting as referenced between DTS, the DTS and United
2 Way contract, it's fundamentally different than the
3 hosting provided by CloudConnect to DTS.

4 Q. And let me ask you a little bit about the
5 contract terms because you reference them.

6 You took a look at the contracts, correct,
7 with CloudConnect and with DTS?

8 A. I did.

9 Q. Okay. And you noticed that there were
10 similarities in several of the provisions within the
11 contract, right?

12 A. Many, yes.

13 Q. Did that surprise you?

14 A. No.

15 Q. And why is that?

16 A. It is common practice. So when an original
17 manufacturer, right, an original provider of services
18 intends their services to be reselled through a
19 reseller, they're making a commitment to those
20 resellers.

21 Those technologies -- this lower left-hand box
22 called CloudConnect hosting here, the services in that
23 are going to be passed forward to the end customer,
24 which in this case was the United Way. And so it makes
25 sense to me, and is common practice in the industry, to

1 take certain provisions, things that DTS doesn't do for
2 itself and relies on CloudConnect for, to pass those
3 forward in the contract.

4 Q. So basically mirroring certain provisions of
5 the contract because it basically is taking the language
6 of CloudConnect and passing it through the contract?

7 A. Correct. So, as an example, going back to the
8 idea of geographic diversity, geographic diversity is
9 something that is provided by CloudConnect inside of
10 their infrastructure and has promised that to DTS. DTS
11 is now saying to the United Way there exists this
12 provision for regional diversity, and that is passed
13 through using the language of CloudConnect.

14 Q. Okay. Let me ask you, what are some of the
15 significant costs that someone like DTS might incur in
16 this environment if they're providing services to the
17 United Way?

18 A. Yes. So a lot of it has to do with expertise,
19 right? In order to provide these types of services, a
20 cloud service, you need various roles, right? You need
21 a networks engineer, a security person, application
22 engineers. And many of those specializations, as well
23 as some of the things that I've listed here as examples
24 on the blocks, are not spelled out anywhere in these
25 contracts. Nowhere will you find something like VDI

1 imaging, right, but that requires a specialist in order
2 to go in and create those images and make them
3 available. That's a service that is something DTS would
4 have had to do in order to make the VDI environment
5 useful.

6 Q. So let me ask you in regard to that idea of
7 having people necessary to create this, is there a
8 difference between how many people you might need to
9 kind of create these environments versus once they're
10 created to maintain them?

11 A. Yeah, so that's a different skill set
12 altogether.

13 So when you're creating the environment,
14 there's kind of a flurry of activity of course, there's
15 a lot of engineering expertise that is required, and
16 then ongoing support could be less.

17 Q. Okay. So, for example, you heard Mr. Meyer
18 testify relative to the number of individuals he's
19 using. If I recall correctly -- well, actually let me
20 ask you. What was your recollection of his testimony on
21 how many people he needed to kind of run the system?

22 A. Yeah, I recall him saying that in -- well,
23 this is now, right, so this is a different time period,
24 I recall him saying that it was six to eight people plus
25 himself.

1 Q. Okay. And compared to the initial setup if
2 you had to initiate a system like this --

3 A. Yeah.

4 Q. -- generally what would you think in your
5 expertise it would take to kind of initiate this
6 process, not just maintain it?

7 A. Yeah, I wouldn't be able to exactly pinpoint
8 it without analyzing the environment, which of course we
9 couldn't do, but it would be more. It would be more
10 than that.

11 Q. So let me ask you, in regard to the cost of
12 running programs. So, for example, you heard the
13 testimony of Mr. Meyer as to the costs of currently
14 maintaining the IT environment at the United Way,
15 correct?

16 A. That's correct.

17 Q. Okay. And do you recall generally what his
18 annual costs were, roughly?

19 A. I don't remember exactly, but I believe it was
20 in the realm of a million or so, something like that.
21 Maybe you can remind me.

22 Q. Sure. Does around 800 plus thousand sound
23 about right?

24 A. Yeah, that sounds right. Yeah, thank you.

25 Q. So in regard to that, and maintaining it,

1 would the cost to kind of initiate and design and
2 implement these programs add any significant cost versus
3 just maintaining it once it's up and running?

4 A. Yes. So there's two things you would have to
5 look at in order to evaluate that.

6 The first is that the overall cost of cloud
7 solutions over the last say five years has dramatically
8 reduced, and so the cost of even maintaining the same
9 service is going down and is less in today's money.

10 It also would have required a greater cost in
11 the beginning because there would have been frankly more
12 engineering activity in order to build them. You need
13 less people in general to maintain a system than you do
14 to build it in the first place.

15 Q. So if I understand you correctly, to build it
16 and implement it you potentially are going to need more
17 people and there's going to be a higher up front cost,
18 and to maintain it is going to potentially cost less,
19 especially in light of the technology today where costs
20 are less for IT?

21 A. That's correct.

22 Q. Okay. I want to ask you a little bit about
23 profitability and outsourcing.

24 A. Sure.

25 Q. Can you talk a little bit to the Judge about

1 what your view of the model that United Way had, you
2 know, in-house versus outsourcing and your review of
3 that?

4 A. Yeah. So the model that they used in terms of
5 offshoring and outsourcing IT is fairly common. It's
6 fairly common in the industry to look to international
7 providers in order to keep costs constrained in an
8 appropriate way, and yeah.

9 Q. And so, for example, outsourcing services to,
10 for example, Pakistan and hiring programmers or
11 engineers in Pakistan, would you agree with the idea
12 that that is going to be a lower cost for those services
13 versus the cost if you paid that same engineer in the
14 United States?

15 A. Typically, yes. The salaries in countries
16 such as Pakistan are dramatically lower.

17 Q. And as a result, would you agree that that can
18 increase the profit margin of a company utilizing that
19 outsourcing model?

20 A. Yes. So to give an example, in my own company
21 we use software engineers in Costa Rica who are
22 potentially -- that are paid half roughly of what a
23 person here would cost, and they're mixed in where
24 appropriate, but the hourly rate to the customer is
25 roughly the same. And so the profitability on one of

1 those engineers is significantly more.

2 Q. And so in general terms when you use this
3 outsourcing model that we're talking about and using an
4 individual that may cost half of or significantly less
5 than an individual in the United States, what is
6 typically the profit that you might see an IT company
7 such as DigitalNet and other similar companies make?

8 A. Yeah, so for an onshore company using current
9 resources, you know, on shore resources, we generally
10 see software development and IT services profit margins
11 sitting somewhere in the neighborhood of 30 percent.

12 In offshore environments of course it's
13 situationally dependent but can be north of that.

14 Q. So above 30 percent?

15 A. Sure. Yeah, without an issue.

16 Q. I want to ask you a couple of questions about
17 metadata.

18 MR. HUNTER: Objection, your Honor. None of
19 this was in Mr. Sgro's report. We've received no
20 information about what he's going to testify to or the
21 basis of his testimony.

22 THE COURT: Why is that?

23 MR. HARRINGTON: Yeah, I'm asking him to
24 comment on testimony that's been adduced during the
25 course of trial relative to metadata. I think he could

1 comment on things that might be relative to other
2 testimony.

3 THE COURT: Why do you think that? I mean,
4 he's an expert. Isn't he supposed to disclose his
5 opinions in advance and the basis for them?

6 MR. HARRINGTON: I assumed, Judge, that given
7 other information that sometimes comes up during the
8 course of trial that he would be able to comment on
9 that.

10 THE COURT: Sure, other information that comes
11 up during the course of trial vis-a-vis opinions he's
12 disclosed, but this sounds like it's not an area he
13 disclosed; is that right?

14 MR. HARRINGTON: Yeah, and I would agree with
15 that, Judge. We didn't disclose anything relative to
16 metadata in his expert disclosure. I was asking him to
17 comment relative to other testimony that's been adduced
18 at trial.

19 THE COURT: I'm going to overrule the
20 objection even though it should be sustained.

21 Go ahead. Go ahead.

22 Q. So in regard to metadata --

23 THE COURT: You just gave an opinion about
24 profitability. Have you reviewed the markups in this
25 case?

1 THE WITNESS: I've worked in this model for
2 quite a bit of time, yeah.

3 THE COURT: I don't know what that means,
4 worked in this model.

5 THE WITNESS: I own a company that works on
6 this model.

7 THE COURT: No, have you reviewed the markups
8 in this case, the evidence in this case, several hundred
9 percent routinely?

10 THE WITNESS: Yeah.

11 THE COURT: Do you have an opinion about it?

12 THE WITNESS: No.

13 THE COURT: Okay. All right.

14 Q. So what is metadata on a computer?

15 A. So metadata is data that is attached to a file
16 that shows things about the creation and storage and
17 movement of that file that is not visible in the file
18 itself.

19 Q. Okay. And metadata can be changed?

20 A. Metadata changes all the time.

21 Q. And how is that?

22 A. So metadata is pretty sensitive. If you were
23 to open a file, that would change potentially the
24 metadata. If you were to move it from one place to
25 another, that could potentially alter the metadata. If

1 it was created and copied, that copy of the metadata
2 would maybe be different depending on the way it was
3 reproduced. So there's a lot of ways that metadata can
4 be changed.

5 Q. Okay. And would that include moving documents
6 say from one computer to another?

7 A. Yeah. So there's a possibility where when you
8 take a file from one computer and move it to the other
9 that the metadata could be changed if it was not moved,
10 you know, in a forensic way where that metadata was
11 assured to be preserved.

12 Q. Okay. And --

13 THE COURT: Say that part again.

14 Wait a minute. Let me just read it.

15 If it was not moved in a forensic way, what do
16 you mean by that?

17 THE WITNESS: So there's a way of moving a
18 file and preserving its metadata so that you know that
19 the copy of it is absolutely exact. And if you don't
20 move it in that way, then the file will change.

21 THE COURT: Like, what, downloading it to a
22 thumb drive and saving the thumb drive?

23 THE WITNESS: That would change the metadata.

24 THE COURT: Oh, it would change the metadata?

25 THE WITNESS: Yes. Correct.

1 THE COURT: Okay. I thought -- let me ask you
2 a question about this. I learned a little bit about
3 metadata in this trial that I didn't know. I always
4 thought metadata was a way of perhaps seeing prior
5 drafts of the same document in its various forms as it
6 got to the final version.

7 THE WITNESS: That would be a revision
8 history.

9 THE COURT: That's a revision history. Is
10 that a type of metadata?

11 THE WITNESS: That can be stored as a type of
12 metadata, yes.

13 THE COURT: Not the type that was presented
14 here. The type that was presented here shows me more
15 like who was the author and --

16 THE WITNESS: Location, author, correct.

17 THE COURT: Those are all different types?

18 THE WITNESS: Yeah, that's all metadata, but
19 it is different components of the metadata, correct.

20 THE COURT: Okay. I see.

21 Q. In that regard, if you had a document, let's
22 say a contract --

23 A. Yes.

24 Q. -- but you had multiple versions of that same
25 contract --

1 A. Uh-huh.

2 Q. -- the metadata for each contract might be
3 different based on when it was viewed, correct?

4 A. Correct.

5 Q. When it was opened?

6 A. Correct.

7 Q. When it was edited?

8 A. Where it was created, yes. That's correct.

9 Q. Okay. In regard to profit -- I want to pick
10 up on a question the Judge had raised. You heard some
11 testimony -- you listened to the testimony of Kevin
12 Kennedy in this case, correct?

13 A. Yes, I did.

14 Q. And you heard him talk about the profits that
15 were reported on Mr. Alrai's tax returns, correct?

16 A. Yes, I did.

17 Q. And those profits were in say the 30 percent
18 range, correct?

19 A. 32.5, I believe, yeah.

20 Q. Okay. Is that, based on your knowledge of the
21 industry and experience, in the range of what would be
22 considered a profit with this outsourcing model, a
23 reasonable profit based on this outsourcing model?

24 A. Yeah, I would consider 32.5 percent
25 reasonable.

1 Q. Now, the last thing that I wanted to ask you
2 about was in regard to the provision of services by
3 DigitalNet in regard to the contracts.

4 You reviewed all of the contracts that were
5 issued between United Way and DigitalNet, correct?

6 A. I did.

7 Q. Okay. And in order to provide those services
8 that were called for under the contract, would that
9 require a team of providers?

10 A. Yes. Certainly.

11 Q. Okay. And based on your review and listening
12 to Mr. Naviloff and Mr. Kennedy testify, do you have any
13 opinions or conclusions relative to the Pakistan office
14 of United Way in the provision of services?

15 A. Yeah. IT engineers are generally specialized,
16 and so in order to provide the totality of those
17 services it would have taken various engineers, and I
18 think Mr. Meyer even alluded to currently in the
19 quote-unquote better state of IT, it still takes him six
20 to eight, plus himself, so seven to nine people.

21 I would expect no less than that to have
22 existed out in the Pakistan business unit as a result
23 and potentially more.

24 Q. And where would the potentially more piece
25 come in relative to the provision of services?

1 A. Well, Mr. Meyer -- the environment Mr. Meyer
2 inherited and has since migrated is in much better shape
3 than what my analysis would show Mr. Alrai inherited and
4 what he was working with, and so the amount of
5 engineering activity that is ongoing would have to be
6 less than what was originally needed.

7 Q. Okay. And therefore, in your opinion more
8 individuals or more staff would have been needed
9 potentially to implement those services?

10 A. Yeah, more staff because more subject matter
11 expertise would have been required.

12 MR. HARRINGTON: Judge, I don't have any other
13 questions for Mr. Sgro.

14 THE COURT: All right. We'll do the
15 cross-examination after my -- I have to have another
16 hearing very briefly.

17 I do anticipate being back down here by 2:15
18 though, so we'll do the cross-examination then.

19 MS. LE: Your Honor, should we clear the
20 courtroom for your next hearing?

21 THE COURT: I'm doing it upstairs. Thank you
22 for offering.

23 (RECESS)

24 THE COURT: Mr. Sgro, you're still under oath.
25 You may proceed.

1 MR. HUNTER: Thank you, your Honor.

2 CROSS-EXAMINATION

3 BY MR. HUNTER:

4 Q. Good afternoon, Mr. Sgro.

5 A. Good afternoon.

6 Q. I just have a few questions to ask. Hopefully
7 not too many.

8 Isn't it true you testified that you thought
9 Mr. Naviloff's report was thorough and he did an
10 analysis of the invoices and comparing it to the
11 contracts?

12 A. Yes.

13 Q. And you didn't conduct the same type of
14 analysis of the contracts and the invoices; is that
15 correct?

16 A. No. Many areas of his analysis are beyond my
17 scope of practice and expertise.

18 Q. And you also heard testimony from John Meyer;
19 isn't that right?

20 A. That's correct.

21 Q. And isn't it true that John Meyer, as you
22 testified, is in a better position than you or Mr.
23 Naviloff to assess the system he inherited from
24 DigitalNet and Mr. Alrai?

25 A. I would agree that he knows potentially more

1 about the existing IT system, correct. I was not given
2 an opportunity to analyze it.

3 Q. Right. He's in a better position to evaluate
4 the system?

5 A. Based on my inability to analyze it, yes.

6 Q. Yes. And isn't it true that Mr. Meyer
7 testified that he had about five to eight people I think
8 working on the United Way account?

9 A. Yes. If that's true, yes. It sounds about
10 right.

11 Q. And he also had testified -- isn't it true he
12 testified that he transitioned from OVH hosting United
13 Way's IT environment to Amazon Web Services, AWS?

14 A. He did testify that, yes.

15 Q. And that would include the engineering and
16 programming involved in that transition, right?

17 A. If he provided that engineering, then yes.

18 Q. Yes. And Mr. Meyer testified that that type
19 of service was included in his monthly charge, right?

20 A. He charges a flat rate of \$44,800 a month for
21 all of those services, right.

22 Q. Yes. And Mr. Meyer also testified that he
23 transitioned from SIP.US to 8x8 for the phone system?

24 A. He did testify that, yes.

25 Q. And it's true he also testified that included

1 in his flat rate was the services in transitioning to
2 that system?

3 A. He did testify that, yes.

4 Q. And that -- and he also testified that DTS is
5 currently maintaining and supporting this, I think as
6 you described it, a living system of networks, virtual
7 desktops, and phones. Isn't that right?

8 A. Yes.

9 Q. That includes hosting and maintaining the IT
10 environment. Isn't that right?

11 A. If he said so, yes.

12 Q. And the phones?

13 A. 8x8 is the company that currently hosts the
14 phones.

15 Q. Now, you also talked a little bit about the
16 phone system and the services charged by DigitalNet for
17 that phone system. Do you recall testifying to that?

18 A. Yes, I recall.

19 Q. And you talked a little bit about the pricing
20 and the managed IT services agreement under I think it
21 was application, operating system, and database
22 management for Telephony related consulting?

23 A. I'm sorry. Can you put that back up?

24 Q. Oh, sure. You testified about this service,
25 right, included an application, OS, and database

1 management?

2 A. Yes. That's correct.

3 Q. Okay. And on direct isn't it true you
4 testified that that cost appears appropriate to manage
5 phone services?

6 A. No, that's incorrect. I testified that that
7 cost was what they were charging as a flat fee to manage
8 the legacy phone system that existed.

9 Q. Correct. The legacy phone system that was
10 existing before SIP.US was brought in?

11 A. Correct. I didn't attest to the
12 appropriateness of it, just that that was what they were
13 charging. That's correct.

14 Q. Okay. And you testified that that would no
15 longer go toward managing the phone system after they
16 moved to SIP.US, right?

17 A. I didn't testify that. I actually would note
18 that there's a lot of things in that service bucket,
19 right, so there's -- if you wouldn't mind putting it
20 back up. That's not only for Telephony services but
21 also things like SQL, which is database, Windows Server,
22 many things which still existed.

23 In this type of flat fee, if you would,
24 bucket, it's normal -- each one of these services does
25 not make up a proportional -- an equal component of that

1 \$3,500. So it's reasonable to me that that \$3,500 may
2 or may not have been appropriate depending on these
3 other systems that were there.

4 Q. Sure. But that \$3,500 is charged to provide
5 those services regarding operating system and database
6 management?

7 A. Comprehensively the \$3,500 is for all of those
8 services, yes.

9 Q. Right. And that includes management of the I
10 guess legacy phone system?

11 A. That did include the management of the legacy
12 phone system to my understanding.

13 Q. And I believe you testified that that does
14 not -- that once switched to SIP.US, the Telephony
15 contract, the cost of managing the phone system was then
16 wrapped up in that \$70 per month phone line fee?

17 A. The management required for SIP.US is
18 included, to my understanding, in the \$70 per month per
19 line charge.

20 Q. But isn't it true that DigitalNet never
21 charged less than that \$3,500 per month, which included
22 phone maintenance for the legacy system, after moving to
23 SIP.US?

24 A. That is true that the \$3,500 in my evaluation
25 was not reduced, but it is not \$3,500 for managing the

1 phone system. It's the totality of that work.

2 And so if there was any kind of change in the
3 rest of those services, then a reduction in costs
4 wouldn't have been appropriate.

5 Q. All right. But there was no reduction in
6 cost?

7 A. No.

8 Q. And they were no longer providing services for
9 the legacy phone system after moving to SIP.US?

10 A. As a subset of that \$3,500 block, they would
11 no longer have been supporting the legacy system after
12 moving to SIP.US, correct.

13 Q. Now, you also testified a little bit about
14 geographic diversity.

15 A. I recall.

16 Q. And was it your testimony that geographic
17 diversity could refer to the location of the servers and
18 the client?

19 A. No. I was attesting that -- geographic
20 diversity is in relation to two systems that may host
21 either the same types of data or data may move between
22 them.

23 What I was speculating was that those systems
24 could have been partially at the office of the United
25 Way and one data center or one data center and another

1 data center that was not owned by OVH.

2 Q. In your report you said that you saw no
3 evidence in the contracts between DigitalNet and its
4 subcontractors, or DigitalNet and United Way, that
5 suggests regional diversity of servers or fault
6 tolerance beyond redundancy and backup.

7 THE COURT: You're going way too fast.

8 MR. HUNTER: I'll slow down.

9 Q. In your report, Mr. Sgro, you said that you
10 saw no evidence in contracts between either DigitalNet
11 and its subcontractors, nor DigitalNet and United Way,
12 that suggests regional diversity of servers or fault
13 tolerance beyond that of server redundancy and backup.

14 Isn't that right?

15 A. Could you put that on the slide so I might
16 reference it?

17 Q. Oh, yeah, I can.

18 THE COURT: AUSA Hunter, I know you think
19 you're slowing down --

20 MR. HUNTER: But I'm not.

21 THE COURT: You're not, yeah. It's a little
22 bit of a struggle, so do your best.

23 MR. HUNTER: Okay.

24 Q. So forgive me for underlining, but is this a
25 line from your report?

1 A. Yes, that is correct.

2 Q. Okay. Now, you were here for Mr. Naviloff's
3 testimony?

4 A. I was.

5 Q. And you saw the slides, right, where
6 DigitalNet was saying they would provide a
7 geographically diverse dispersed high availability
8 environment, right?

9 A. You're referencing the 2013 IT managed
10 services contract?

11 Q. Yes.

12 A. They did state that.

13 Q. And the CloudConnect contracts referred to
14 different geographic locations of the CloudConnect
15 infrastructure. Isn't that right?

16 A. Yes, the CloudConnect wording suggested that
17 they had multiple data centers and were regionally
18 diverse at that time.

19 Q. And that would be a contract between
20 DigitalNet and one of its subcontractors, right?

21 A. Sure. Yes.

22 Q. That suggests regional diversity of servers.

23 A. That does suggest regional diversity of
24 servers.

25 Q. Okay. So did you just miss that when you were

1 writing your report?

2 A. Could you put the report up? I would like to
3 read that in context.

4 Q. Yeah, absolutely.

5 A. So when I was -- I'm sorry, can you leave that
6 up?

7 Q. Sorry.

8 A. I apologize.

9 Q. No problem.

10 A. I made that comment with regard to the service
11 outage that Mr. Meyer discussed in his interview with
12 the FBI. And so within the service outage described by
13 Mr. Meyer, I see no evidence in the contracts between DN
14 and the United Way that suggests regional diversity of
15 servers or fault tolerance.

16 Q. So regarding the service outage, that was when
17 United Way was contracting with OVH, right?

18 A. That's correct.

19 Q. But not with CloudConnect?

20 A. Yes. That appears to be a mistake.

21 Q. Okay. You also mentioned that setup is the
22 most expensive part -- setup was the most expensive
23 charge compared to the ongoing service charge, the
24 month-to-month charge of the hosting environment?

25 A. It is typical for setup charges and the

1 building of infrastructure to exceed the cost of its
2 ongoing maintenance.

3 Q. And isn't it true that during the six years
4 the cost that DigitalNet -- and so isn't it true then if
5 that's the most expensive cost, you're going to expect
6 to see costs down over time? Isn't it true --

7 THE COURT: Hey, slow down.

8 MR. HUNTER: I will take a breath and slow
9 down, your Honor.

10 THE COURT: Yeah, please.

11 Q. Isn't it true, Mr. Sgro, that you would expect
12 then the amount that DigitalNet charged to go down over
13 time if that one-time cost of setup is paid?

14 A. I wouldn't necessarily expect that, no.

15 Q. For it to ever go down?

16 A. You would have to -- in order to understand
17 whether or not the costs should be reduced over time,
18 you would have to analyze the environment and understand
19 what services were being used and whether or not there
20 was an increase in the amount of services.

21 For instance, licensing costs could go up
22 after the initial build-out as a result of hiring
23 employees or things like that. And so without seeing
24 the environment and not being able to analyze it, I
25 wouldn't be able to give you an accurate answer to that.

1 Q. Right. So you don't know what extra services
2 DigitalNet provided above and beyond what was built from
3 the vendor and what's in their contracts, right?

4 A. I was never able to analyze the environment,
5 correct.

6 Q. You did receive a two terabyte hard drive with
7 images of the IT help desk computers on Mr. Alrai's
8 United Way computer though, right?

9 A. I received a drive that had those computers on
10 those, but those are not the environment that we're
11 speaking of.

12 Q. Of course. And regarding the setup of the
13 phones and of the servers, isn't it also true, based on
14 the invoices, that DigitalNet billed separately for all
15 that setup?

16 A. DigitalNet did bill separately for setup of
17 certain services; that is correct.

18 Q. Just a moment.

19 Sir, what kind of markups do you and your
20 company bill for your clients' IT services that you
21 provide?

22 A. The services we provide fall into various
23 buckets. In general, we provide markup that is, you
24 know, anywhere from 30 to maybe 45 percent depending on.

25 Q. Okay. So a 32 percent markup is reasonable, I

1 think you said?

2 A. That would be reasonable for our services,
3 yes.

4 Q. Okay. Is a hundred percent markup reasonable?

5 A. I would have to evaluate the service in order
6 to understand what is reasonable, but in our business
7 that would not be typical.

8 Q. Okay. Is a 500 percent markup reasonable?

9 A. My answer would be the same.

10 Q. What about a 1000 percent markup; is that
11 reasonable?

12 A. Still the same, counselor.

13 MR. HUNTER: Nothing further.

14 MR. HARRINGTON: May I inquire, your Honor?

15 THE COURT: You may as long as you speak
16 slower.

17 MR. HARRINGTON: I haven't been chastised yet,
18 Judge.

19 MR. AYER: But the rest of us have.

20 MR. HARRINGTON: Blame Mr. Hunter.

21 THE COURT: For what it's worth, you know, I
22 was a big violator of that rule myself when I had your
23 job, and I understand how easy it is to get moving.

24 Go ahead.

25 MR. HARRINGTON: Thank you, Judge.

REDIRECT EXAMINATION

BY MR. HARRINGTON:

Q. So just a couple of questions for you.

Attorney Hunter had put up the part of your report that was talking about the outage with OVH, correct?

A. That's correct.

Q. And you had indicated that there was a mistake relative to the mention of CloudConnect versus OVH, right?

A. Yeah, I believe we were talking about one data center versus the other.

Q. Sure, but the information -- the mistake was saying CloudConnect versus OVH, correct?

A. Yeah, we transposed the name of the company by accident.

Q. So the information or the substance of the statement is not a mistake. It's just the reference to CloudConnect versus OVH?

A. That's correct.

Q. Okay. In regard to -- I want to talk to you just very briefly about SIP and the invoice that we were talking about.

You may recall it was the invoice for SIP which was roughly about \$1,000 per month, correct?

1 A. I recall.

2 Q. And then there was a bill from DigitalNet that
3 was for about \$13,000 roughly, correct?

4 A. That's correct.

5 Q. And one of the things that you were trying to
6 explain to the Court was relative to the different
7 services that were being provided by DigitalNet relative
8 to that \$13,000 cost, correct?

9 A. That's correct.

10 Q. Okay. And so when you were talking about
11 that, one of the questions that was asked of you by the
12 Judge, and the prosecutor just touched on it as well,
13 was relative to markup. I wanted to kind of bring you
14 back to that because I wasn't sure after listening to it
15 whether you were tracking the same question I was. I
16 want to make sure I'm on the same page and that you
17 answer the Judge's question if you can.

18 A. Fair enough.

19 Q. Which is, we have a \$1,000 bill from SIP and a
20 \$13,000 bill from DigitalNet, and that was characterized
21 as there's a markup in that, correct?

22 A. That's how it was characterized in the RSM
23 report.

24 Q. And so one of the things the Judge asked you
25 is, you know, what do you think of that markup, do you

1 have an opinion about that markup, and I want to make
2 sure that you have an opportunity to answer that in a
3 little bit more detail because one of the things you
4 were talking about were other services that were beyond
5 that 1,000. So if you could answer that question a
6 little more fully, I would appreciate it.

7 A. Yeah, so in my analysis I would not call that
8 markup. It is true that the SIP.US component of that
9 service cost DTS roughly a thousand dollars a month.
10 However, there are many other services that go into
11 providing a Telephony system, networking, setup of
12 the -- not just the initial setup, but setup of new
13 phones. There is the messaging system. There's all
14 sorts of technical expertise that is required to make
15 the phones work the way we expect when the phone is
16 picked up.

17 Now, it's very hard to trace into the
18 invoices, and we see that example, which is actually an
19 example that was brought up by Mr. Naviloff. There's I
20 believe it's an \$890, \$899 charge, forgive me, I'm over
21 here trying to remember, for bandwidth for the service
22 that was not able to be traced into any of the invoices,
23 and that is another component which would have been a
24 cost paid as part of delivering the Telephony service.

25 You can see that it's not -- it's not clear

1 without really analyzing the system itself and its setup
2 and how it is used in order to say, you know, what part
3 of those services -- or what part of that money would
4 have been truly markup in terms of profit versus the
5 cost of providing that service.

6 Q. And so in that regard we're talking about this
7 \$13,000 bill from DigitalNet?

8 A. Right.

9 Q. And that bill comes in as managed Telephony
10 services, correct?

11 A. That's correct.

12 Q. Okay. And in that regard you weren't trying
13 to tell the Judge, well, geez, I don't have any comment
14 on that markup.

15 Would it be fair to say that based on what you
16 understand would be required to manage a Telephony
17 service as it existed in the cloud, that type of invoice
18 or cost would be an appropriate cost?

19 A. Yeah. Again without analyzing the actual
20 environment, it's hard to actually give an opinion on
21 the appropriateness of cost.

22 What I can say definitively is that much of
23 that cost should have been costs incurred by DTS to
24 provide that service, right, but from an engineering
25 standpoint and other providers, such as bandwidth.

1 Q. Okay. And so certainly in regards to saying
2 that you didn't have a comment on the markup, you're not
3 trying to tell the Judge that you think there was an
4 inappropriate markup in price or it was too high a
5 markup, that's not the message you're trying to convey
6 to the Judge?

7 A. No, not at all.

8 MR. HARRINGTON: I have no other questions,
9 Judge.

10 MR. HUNTER: Very, very briefly, your Honor.

11 RE CROSS-EXAMINATION

12 BY MR. HUNTER:

13 Q. Regarding the OVH outage, Mr. Sgro, I think
14 you said outages are fairly normal?

15 A. Technical systems break.

16 Q. Is a three-to-four day outage a normal
17 occurrence?

18 A. Depending on the circumstances of the
19 occurrence I would say it is not typical that services
20 would go down that long, but it's not out of the realm
21 of possibility surely.

22 Q. Regarding costs incurred by DigitalNet to
23 provide various services, isn't it true that you didn't
24 analyze DigitalNet's financial records or other business
25 records to determine the costs that they incurred in

1 providing those services?

2 A. No. That would be outside of my scope of
3 practice.

4 Q. So that sort of accounting work is outside
5 your scope of practice?

6 A. Certainly.

7 Q. So if the Court adopts the accounting analysis
8 of Mr. Naviloff or some of the analysis done by Mr.
9 Kennedy, which again you say is beyond your expertise in
10 the accounting, would you agree that a 1,000 percent
11 markup is abnormal for IT?

12 A. Well, there's two parts of your question.
13 I'll try to answer them separately.

14 The first is that -- yeah, so if the Court
15 adopts that analysis, I would say my only issue with the
16 analysis is it seems to be bucketed, from my
17 understanding of the testimony, into the analyzed
18 services and not analyzed services, and there's a lot of
19 inferences and discussions about how services belong --
20 which services belong in which bucket, and I think
21 there's still questions in my mind about how that was
22 achieved given that we don't have the ability to analyze
23 the actual environment or the communications, the
24 delivery of the actual engineering services.

25 But in any case, yeah, I would say that a

1 thousand percent markup, if that were in fact the case,
2 would seem abnormal at least for my business.

3 Q. And just to be clear, isn't it true you have
4 no opinion about Mr. Naviloff's analysis of the money
5 being spent on personal versus business related
6 expenditures?

7 A. I did not analyze any of the personal
8 expenditures.

9 MR. HUNTER: No further questions.

10 MR. HARRINGTON: I have nothing else for the
11 witness, your Honor.

12 THE COURT: Thank you, sir.

13 THE WITNESS: Thank you.

14 MR. HARRINGTON: Your Honor, the defense
15 rests. We have no further witnesses to present.

16 THE COURT: Thank you, Mr. Harrington.

17 All right.

18 MR. DAVIS: Your Honor, the government would
19 like to call Mr. Naviloff briefly in rebuttal.

20 THE COURT: What's your position?

21 MR. HARRINGTON: I'm not sure what the
22 rebuttal is. I guess we'll find out.

23 THE COURT: Do you object to them calling a
24 rebuttal witness, and if so, on what grounds?

25 MR. HARRINGTON: I don't have an objection to

1 a rebuttal witness if the subject matter is appropriate.

2 THE COURT: Thank you.

3 Mr. Naviloff, you may retake the stand.

4 You don't need to be sworn in again. You're
5 still under oath.

6 THE WITNESS: Understood.

7 MR. DAVIS: Your Honor, the subject matter is
8 the testimony by both defense experts about profit
9 margin and the relevant profit margin based on tax
10 records.

11 THE COURT: Please proceed.

12 MR. DAVIS: All right.

13 REBUTTAL TESTIMONY OF GREG NAVILOFF

14 DIRECT EXAMINATION

15 BY MR. DAVIS:

16 Q. Good afternoon, Mr. Naviloff.

17 A. Good afternoon.

18 Q. Now as part of your work in this case as an
19 expert, did you have occasion to review the expensing
20 that was done in connection with Mr. Alrai's taxes?

21 A. Yes, I did look at the tax returns for the
22 years that they were provided, which was --

23 Q. And as part of that, did you examine items
24 from Mr. Terry's file that were both tax returns and
25 work papers pertaining to Mr. Alrai?

1 A. Yes, I did.

2 Q. All right. And did you notice a change over
3 time in the profit margin that Mr. Alrai was showing in
4 his returns between 2013 and 2018?

5 A. Yes. It fluctuated significantly among those
6 years.

7 Q. So showing you first Exhibit 927, the first
8 page, are these slides that you prepared and have
9 previously been disclosed?

10 A. Yes, it's my understanding.

11 MR. DAVIS: Your Honor, I move to admit 927
12 and strike the ID.

13 MR. HARRINGTON: No objection to that.

14 THE COURT: It's admitted.

15 (Government's Exhibit 927 admitted)

16 Q. All right. And just looking briefly at this,
17 this is a summary of the tax returns on the 1040
18 Schedule C which we've already looked at a little bit,
19 profit or loss from business, correct?

20 A. That's correct.

21 Q. And it's for the years 2013 through 2017,
22 which are the tax years you had from Mr. Terry?

23 A. Correct.

24 Q. All right. And it shows -- you show on the
25 bar charts gross receipts or sales on Schedule C and

1 also gross receipts or sales per the bank statement
2 deposits from United Way and Robert Allen, correct?

3 A. That's correct.

4 Q. All right. And you also show on the gray line
5 another calculation; is that right?

6 A. Yes.

7 Q. All right. And what does that gray line show?

8 A. That is taken from Schedule C, line 5, so it's
9 actually a calculation based upon that line, but it
10 would take the gross sales and compare it as a
11 percentage of the gross profit that was being reported.

12 So the difference between the gross
13 receipts/sales and the gross profit would be the cost of
14 services, right? And so, in essence, the cost of doing
15 all the labor and materials associated with providing IT
16 solutions to DigitalNet's customers.

17 Q. Okay. So it's actually a gross profits line
18 item on the Schedule C on the tax return, right?

19 A. Correct.

20 Q. All right. And you used it to calculate a
21 percentage that represents the gross profit percentage,
22 right?

23 A. That is correct, yes.

24 Q. And did you hear the defense experts testify
25 that 32 percent, 32.5 percent might be reasonable in the

1 IT business?

2 A. Yeah. I believe they were referring to the
3 net income, I'm guessing, rather than the gross profits.

4 However, Mr. Sgro made reference to
5 essentially the gross profits, and I believe that may
6 have been more apples to apples at 35 percent, but it
7 wasn't quite clear which lines they were referring to.

8 Q. Okay. All right. But what you've calculated
9 for 2013 is a gross profit. And just looking at the
10 scale on the right there, you're right around almost 80
11 percent in 2013, correct?

12 A. Yes. That's correct.

13 Also, in just making mention of Mr. Sgro's
14 testimony, you know, the statement that was made was
15 that in essence that there would be more costs related
16 to structuring and man-hours and potentially labor that
17 was incurred up front as DigitalNet and Mr. Alrai looked
18 to overhaul the system that was inherited and revamp it
19 to function more efficiently.

20 Q. In other words, you would expect a lot of
21 start-up costs early?

22 A. Yes. Exactly.

23 Q. All right. So in 2014 your chart shows gross
24 profit went, what is that, somewhere north of 80
25 percent, right?

1 A. That's correct, yes.

2 Q. All right. And then something happened to the
3 gross profit amount, right?

4 A. Yes, I agree. So we go from in excess of 80
5 percent gross profit percentage to somewhere north of 50
6 percent and continued downward significantly into 2016
7 where it was slightly over 40 percent and remained.

8 Q. All right. So 2016 we're showing gross profit
9 there at just maybe even slightly under 40 percent,
10 right?

11 A. Correct.

12 Q. Okay. Now what happened?

13 A. Well, that's what I wanted to know. It was
14 the source of some head-scratching as far as
15 understanding what was occurring in the business.

16 Q. Okay. So let's look at Exhibit 207, page 568,
17 which is a work paper from the 2016 Mr. Terry work
18 papers.

19 MR. DAVIS: I'm sorry. Exhibit 207, page 568.
20 I'll have to go back.

21 THE COURT: Take your time.

22 Q. All right. Do you see that page?

23 A. Yes, I do.

24 Q. And is that from the work papers that were
25 used based on information provided by Mr. Alrai to his

1 CPA?

2 A. That's my understanding, yes.

3 Q. And we can see the income. The income for
4 DigitalNet that year is about 1.5 million at the top,
5 right?

6 A. That's what the schedule is showing, yes.

7 Q. Okay. And then there's some expenses you
8 would expect to see in a business, and that's payroll
9 and payroll taxes and subcontractors, right?

10 A. That's correct.

11 Q. So payroll is all the people you're employing
12 working for you, right?

13 A. Yes.

14 Q. And then subcontractors is the vendors you
15 have subcontracted with to provide services, right?

16 A. Correct.

17 Q. Okay. And that could be say a CloudConnect
18 that's providing a service to United Way?

19 A. It very well could be, yes.

20 Q. Okay. All right. But that whole total there,
21 and I'm just looking at ballpark, that's only a little
22 bit more than \$500,000, right?

23 A. That's correct.

24 Q. All right. And so the difference between the
25 1.5 at the top and the cost of your employees and your

1 subcontractors is a million bucks, right?

2 A. That's correct.

3 Q. All right. And then we see a bunch of
4 expenses. There's telephone, there's insurance, office,
5 and then a whole lot of other stuff, household,
6 utilities, travel, parking, professional fees, I guess
7 that's lawyers, automobile, meals and entertainment,
8 recreational, right?

9 A. Correct.

10 Q. All right. But none of those is big money on
11 this chart, right, except for maybe the 60,000 in
12 travel?

13 A. Well, I would say that those are all
14 attractive dollars to me, but they don't -- in total
15 they're maybe a little over a hundred thousand.

16 Q. Right. But you've still got a big delta
17 between the 1.5 million you're earning and what you're
18 actually showing as expenses for your business, right?

19 A. Correct.

20 Q. All right. But then we have another item,
21 don't we, and it says IT support. What is that?

22 A. I'm not sure.

23 Q. Well, what's the amount?

24 A. It's \$1,048,769.94.

25 Q. All right. And COS, is that cost of service?

1 A. That is what would commonly be COS in a
2 business of this type.

3 Q. All right. So now we're talking real money,
4 right?

5 A. Well, it's over a million.

6 Q. Right. And what this sheet shows is that
7 against an income for DigitalNet of 1.5 we can account
8 for 1.8 in business expenses, right?

9 A. The key to this schedule and the way I viewed
10 it, the cost of sales, and I believe it's that combined
11 with the subcontractors, gets you to the total that was
12 reported on Schedule C as the cost of sales that gets
13 you from that gross receipts down to the gross profit
14 that we were showing in the last slide.

15 Q. Okay. So there are components already in
16 there that are counted in the cost of services?

17 A. So to analyze the Schedule C, I needed to
18 understand the components.

19 Q. Okay.

20 A. And one of those components and the largest of
21 those components was this cost of service IT support
22 line.

23 Q. All right. So you had questions about IT
24 support, right?

25 A. That's correct.

1 Q. All right. So let's look very briefly at the
2 returns.

3 MR. DAVIS: Exhibit 153, if we can go just to
4 the 1040 face sheet. So that's the estate and trust at
5 the beginning, but if we flip through that -- we've done
6 this once before.

7 Q. Okay. So now we're at the -- this is Exhibit
8 153, and we're at the 2016 individual return, right?

9 A. Yes.

10 Q. All right. And what we see is a business
11 income or loss on line 12 of almost 300,000, right?

12 A. That would be business income, yes.

13 Q. Right.

14 MR. DAVIS: Business income on line 12. Do
15 you see that, Ms. Sheff?

16 Q. Okay. So that's the bottom line that goes on
17 the front of the 1040, right?

18 A. Yes.

19 Q. But to understand how it got there, we have to
20 go to Schedule C, right?

21 A. Correct.

22 Q. And Schedule C, if we flip through just past
23 Schedules A and B, here we are, profit or loss from
24 business, right? And this shows on line 1 \$2 million
25 gross receipts or sales, right?

1 A. Correct.

2 Q. Okay. And then on line 4 what does it show?

3 A. That's the -- it says cost of goods sold, but
4 essentially, given the nature of this organization, it's
5 the cost of services.

6 Q. All right. So that's more than \$1.4 million
7 cost of goods sold, right?

8 A. Yes. 1,446,000.

9 Q. And you subtract that right from gross
10 receipts or sales and you get your gross profit in line
11 5, right?

12 A. Correct.

13 Q. And your gross profit is now 585 grand, right?

14 A. Correct.

15 Q. Okay. So that year we had a 1.4 cost of goods
16 sold. Let's just compare again 2013.

17 MR. DAVIS: Can we go to Exhibit 204 briefly.

18 Q. Back in 2013 we had the same 1040 filed,
19 right?

20 A. That's correct.

21 Q. And that year we showed in line 12 business
22 income of over \$900,000, right?

23 A. Correct.

24 MR. DAVIS: All right. And let's go to
25 Schedule C.

1 Q. On Schedule C here, a profit or loss from
2 business, we see gross receipts of sales of 1.2 million,
3 right?

4 A. That's correct. That agrees with the amounts
5 that the United Way and --

6 Q. Okay. Then we go to cost of goods sold, line
7 4, and what do we see?

8 A. So the cost of services listed here, cost of
9 goods sold, is 224,836.

10 Q. All right. And this is the first year that
11 DigitalNet is reporting taxes, right? This is kind of a
12 start-up year, 2013?

13 A. My understanding is that AISA Consulting, I
14 think it was incorporated or, excuse me, registered in
15 maybe 2012. I'm not sure if there's a tax return for
16 2012.

17 Q. All right. But this is early in the story,
18 not late, right?

19 A. Seemingly.

20 Q. Right. And on line 5 DigitalNet is showing --
21 or the profit or loss from business sheet is showing
22 more than a million dollar gross profit in 2013, right?

23 A. Yes.

24 Q. And three years later, in 2016, we just saw
25 they're only showing 500,000 and something gross profit,

1 right?

2 A. Yes, it decreases.

3 Q. All right. And that's because the cost of
4 goods sold over those same three years went from 224K in
5 2013, right, right in front of us?

6 A. Correct.

7 Q. And then 1.4 million in 2016, right?

8 A. Correct.

9 Q. So you had a question?

10 A. Yes. The 1 million related to IT services in
11 2016.

12 Q. And did you then endeavor to look at a little
13 more closely in 2016 what were the components of this
14 cost of goods sold claim of 1.4 million?

15 A. That was my question and that was what I began
16 to search through the information, the tax information
17 and accounting support.

18 Q. Okay. So showing you 207c, which is -- I'm
19 sorry. Is 207c also among the work papers Mr. Terry
20 provided?

21 A. Yes.

22 Q. All right.

23 MR. DAVIS: Your Honor, move to admit 207c and
24 strike the ID.

25 MR. HARRINGTON: No objection.

1 THE COURT: Admitted.

2 (Government's Exhibit 207c admitted)

3 Q. And you can see on the top this is 2016
4 combined from all spreadsheets?

5 A. Correct.

6 Q. All right. And what on this sheet was
7 important to you as you went about your inquiry?

8 A. Well, I could tell from at least the far right
9 column that there were certain adjustments being made
10 presumably to take information that Mr. Alrai provided
11 to his accountant to presumably what ended up in various
12 parts of his tax return and identified the cost of goods
13 sold, initials, or acronym next to the subcontractors
14 and the IT support, which are the very two bottom rows.

15 Q. Okay.

16 A. The total of which agreed to the amount shown
17 on Schedule C, cost of goods sold.

18 Q. Okay. So you're talking about the number at
19 the very bottom down there, right?

20 A. Correct.

21 Q. All right. Now, did you also look at the
22 associated work papers for Mr. Alrai that showed the
23 activity in the DigitalNet bank account over that same
24 period?

25 A. Yes. That is correct.

1 Q. And this is again for 2016?

2 A. Correct.

3 Q. All right. And did this particular page come
4 to your attention?

5 A. It did. This and the following page.

6 Q. Okay.

7 A. So this is the bottom section of this page
8 after the sales of 1,532,000.

9 Q. So that sales, that's an income number, right?

10 A. Yes, that ties partially to their income.

11 Q. All right. But below that, what did you find?

12 A. This is a listing of dates, amounts and
13 transaction type, along with a description indicating
14 that they were payments to vendors for utilities, goods,
15 and services.

16 Q. All right. And they go all the way down the
17 page, right?

18 A. Correct.

19 Q. And then they go on over to another page,
20 right?

21 A. Correct. I believe they are in date order.

22 Q. All right. And I'm showing you that next page
23 of Exhibit 207c. There's all these other checks, right?

24 A. Correct.

25 Q. All through 2016. And then a total for

1 something called IT support. Do you see that?

2 A. Yes, I do.

3 Q. All right. Again, that number has nothing to
4 do with payroll for programmers or help desk people,
5 right?

6 A. Well, looking at this I don't know what it
7 relates to. I know it rolls up to and it's a jargon for
8 meaning that number can be taken and added to the
9 subcontractor amount, and that total equals the cost of
10 services.

11 Q. All right. So the subcontractor amount is
12 also separate. This isn't the money being paid to the
13 CloudConnects of the world to provide IT services,
14 right?

15 A. Presumably not.

16 Q. Okay. All right. So, did you then decide to
17 look at some of these checks to try to figure out what
18 they were?

19 A. I did. I made a judgmental sample selection.

20 Q. All right. So showing you now the second
21 slide on Exhibit 927 -- we just have four slides there.
22 This is the second one.

23 What does this show, Mr. Naviloff?

24 A. This indicates the cost of goods sold analysis
25 that I performed based upon information contained in the

1 1040 schedules from 2013 through 2017.

2 Q. All right. And at the top we can see the
3 growth from 224 to 1.4 million that we've already talked
4 about, right?

5 A. That's correct.

6 Q. But what are these five entries with dates in
7 2016? What did they refer to?

8 A. Those are the dates that appeared on the
9 spreadsheet that you showed the Court just a moment
10 earlier.

11 Q. Okay. And are those particular transactions
12 on those dates that interested you?

13 A. Well, like I said, this is really a judgmental
14 sample. I looked at larger disbursements from that
15 list, and you can see here, in the far right column,
16 these are either larger amounts over 50,000 or they were
17 round dollar amounts. So I picked a couple of
18 relatively smaller amounts that were \$10,000 of
19 disbursement. So my judgment came into play here, and I
20 picked the ones that were either a large amount of
21 dollars, large dollars, or smaller round dollars.

22 MR. DAVIS: Okay. So next slide, please, the
23 third page of Exhibit 927.

24 Q. What does this show?

25 A. This is -- if you go back to the last item, it

1 may be helpful.

2 MR. DAVIS: All right. Go back, if you would,
3 please.

4 A. This is just support for the first one that I
5 tested, and you can see from my observation there
6 \$82,181.06. That amount I was able to look back at the
7 bank statements and identify that as I guess, number
8 one, looked back at the DigitalNet invoices and noticed
9 it was the same amount as invoice 15042 plus 15532. So
10 it was essentially what appeared to be the payment of
11 two invoices from United Way to DigitalNet matched that
12 \$82,181.06. So that's amount tied to cash coming in,
13 not cash coming out, and that cash came in on April 12,
14 2016, according to the bank records.

15 Q. In other words, you're saying that you tied an
16 \$82,000 revenue for DigitalNet to an 82,000 expense
17 being claimed by DigitalNet; is that right?

18 A. Yes. Exactly that.

19 Q. All right. And what else did you find and
20 particularly involving inter-agency or inter-account
21 transfers?

22 A. Well, similar to that, if you look at the next
23 transaction, I tested another 400,000. And once again,
24 this is an instance where I didn't see necessarily a
25 revenue amount equating to this dollar amount, so it

1 wasn't similar to the last one, a revenue that appears
2 to have been stated as an expense, but rather this one
3 was an amount that was transferred between Mr. Alrai's
4 accounts, or the DigitalNet accounts, between DigitalNet
5 anyway and -- I'm going to mispronounce it -- AISA
6 Consulting.

7 So this is a transfer between two accounts,
8 not an outflow, that was apparently recorded as an
9 expense.

10 Q. Well, it certainly is an outflow of the
11 DigitalNet operating account, right?

12 A. It was an outflow from DigitalNet to an AISA
13 account.

14 Q. But it's just going to an AISA account, which
15 is a separate bank account also controlled by Mr. Alrai,
16 correct?

17 A. Yeah, I'll refer back to the testimony that I
18 gave yesterday. The analysis I was able to perform
19 identified seven accounts that include both the AISA
20 accounts as well as the accounts that DigitalNet owned
21 as an entirety that explained the money coming in and
22 out of the business.

23 Q. Okay. And very briefly, because I want to
24 wrap up, what is the \$93,000 amount also in red?

25 A. That's one where -- similar to the April 19th

1 amount for 82,000, this -- there was no amount, no
2 disbursement amount I could identify associated with the
3 93,000.

4 However, I did identify a positive 99,166,
5 which was close. But once again, this is one where
6 there were transfers similar to the March 31, 2016,
7 400,000, and there were transfers in this amount but
8 they appeared to be between accounts and not out of the
9 account.

10 Q. Okay. All right.

11 MR. DAVIS: So let's go to the next slide now.

12 Q. And just briefly, this slide is entitled
13 inter-account transfers within the analyzed accounts,
14 example of movement of funds with analyzed accounts
15 after receipt of revenue from the United Way, correct?

16 A. Yes. And I'll apologize to your Honor for all
17 these numbers on the spreadsheet. It's meant to
18 demonstrate the cash activity as per the bank
19 statements, the combined bank statements of the seven
20 accounts that contained all the activity for DigitalNet,
21 and it included the AISA Consulting accounts.

22 Q. All right. And just one quick way to look at
23 it is this counterparty account column, right?

24 A. Yes.

25 Q. Many of the counterparties are not some

1 business, right?

2 A. That is correct.

3 Q. They are a DigitalNet account or they're --
4 well, mostly DigitalNet accounts, right?

5 A. That is correct.

6 Q. Including this one here. It's a \$60,000
7 transfer from one DigitalNet account to another one,
8 right?

9 A. Correct.

10 Q. And then an \$18,000 transfer below that from
11 one DigitalNet account to another, right?

12 A. Correct.

13 Q. And then a \$60,000 one from AISA back to a
14 DigitalNet, right?

15 A. Correct.

16 Q. All right. So what's the bottom line on these
17 ten inter-account transfers? What do you show here?

18 A. Yeah, so the takeaway here, if you look at
19 that column, if you add up all that activity, it nets to
20 zero. From my analysis some of these appear to be
21 savings accounts so there could be money going from one
22 account to another to earn interest. So that's
23 certainly a plausible explanation for some of the
24 transfers.

25 But if you look back at April 12, 2016, that's

1 the source or money coming into the account during this
2 time period. So during this April 12th through April
3 22nd time period the only money coming in is from United
4 Way, and it's the \$82,181.06 that I mentioned earlier.
5 So this is the amount that was essentially the same
6 amount that was recorded as expense as IT related cost
7 of services. However, it ties to this revenue amount.

8 Now, when you look at the inter-account
9 activity, it nets to zero. So that's just all noise.
10 It's just money moving around.

11 Q. Are you familiar with the phrase -- or the
12 word churning?

13 A. Yeah, it's a -- yeah, I guess churning just
14 means, yeah, moving around.

15 Q. All right. And so again at the bottom line
16 you've got 82 grand in revenue for that period, right?

17 A. Correct.

18 Q. And that comes down to a \$121,000 expense
19 claim on a tax return, right?

20 A. Well, yeah, if I can walk you through the
21 other transfer column.

22 So you've got 82,000 in revenue coming in, and
23 then when you look specifically at the line -- and this
24 is the -- well, let's start with the other transfers.

25 So the other transfers are money going out.

1 Those are the ones that we could determine there was a
2 check and money left that combined seven accounts.

3 Q. Right.

4 A. And that totalled \$44,498.59.

5 Q. Right.

6 A. If you look at the list, there's -- the first
7 amount is Commonwealth of Massachusetts. So some sort
8 of payment presumably for taxes. There's a few other
9 smaller amounts for telephone and other seemingly small
10 expenses. There's \$9,000 for the credit card expenses,
11 and my testing of that revealed much of that or some of
12 that at least is likely personal in nature.

13 And then, you know, the next one we see on
14 this list, and the largest on this list, is the Pakistan
15 payment, so 17,960.

16 And then on the very bottom you can see the
17 wages. Those would be the direct wages paid as well as
18 the payroll related to those.

19 So you can see -- it's a good snapshot of the
20 type of activity that was happening in DigitalNet's
21 business for approximately a one-month period of time
22 and the types of expenses they were incurring.

23 Now, what I take away from this is the amount
24 sitting in the inter-account transfers of 82,181, which
25 is the first transaction on April 19, 2016. So that

1 amount appears to get pushed or recategorized as a
2 transfer out when it's really just a transfer between
3 accounts as I mentioned.

4 You add that 82,181 to the \$44,498.59, and
5 that's how you get to the \$121,971.65 that is being
6 portrayed in the tax returns -- expenses in the tax
7 returns.

8 Q. Okay. So last slide.

9 What is this? It's entitled inter-account
10 transfers within the analyzed accounts, example of
11 movement of funds with analyzed accounts after receipt
12 of revenue from the United Way.

13 A. Yeah, so this is just highlighting the math I
14 just did, right? So if you look at the first
15 transaction on April 19th of 2016, you need to add that
16 to the amounts that were transferred out to tie out to
17 the expense that was recorded in his tax return.

18 Q. Okay. So is it fair to say that your analysis
19 at least for this month showed a significant inflation
20 of the actual cost being claimed by DigitalNet?

21 A. Yeah. So the first three selections that I
22 made all resulted in this same observation, that amounts
23 that appeared to net out to zero as inter-account
24 transfers was taken as expenses within the tax returns.

25 Q. All right. And you found -- do you recall how

1 many inter-account transfers you found?

2 A. Over 500.

3 Q. All right.

4 MR. DAVIS: And going back, finally, to the
5 first slide again.

6 Q. So, Mr. Naviloff, you showed in 2013 right
7 about 80 percent gross receipt versus gross profit
8 percentage, right, gross profit percentage?

9 A. Correct.

10 Q. And in 2014 you showed it looks like over 80
11 percent gross profit percentage, right?

12 A. Correct.

13 Q. And as we've already seen, that's cut in half
14 by 2016, right?

15 A. Correct.

16 Q. Now, based on what you found regarding the
17 inter-account transfers and the inflation of the cost of
18 goods sold, do you have any confidence in a conclusion
19 that DigitalNet was making 32 percent profit and that
20 was reasonable?

21 A. No. I would have no ability to rely on the
22 tax returns as a basis for measuring the reasonableness
23 of the profits of DigitalNet or AISA Consulting.

24 MR. DAVIS: Nothing further. Thank you.

25 THE COURT: Cross-examination.

CROSS-EXAMINATION

BY MR. HARRINGTON

Q. So, Mr. Naviloff, on I think it was my cross-examination yesterday of you, I think you agreed with me that you did not conduct an audit of Mr. Alrai's tax returns.

A. I did not, no.

Q. Okay. And so all the information that you have just testified to for the last half hour or so as far as the tax returns and gross profit, all that, you did not actually conduct an audit of the returns, right?

A. I did not.

Q. Okay. So as a result, one of the things that is being talked about here were expenses, right?

A. That's correct.

Q. Okay. And as one of the things that you would do in an audit, which you didn't do, is you would go and you would take a deeper dive and try to verify expenses and things of that nature to make sure they were either an appropriate or inappropriate expense, right?

A. That's correct, yes.

Q. Okay. This graph that's up on the table here that the Judge has been seeing I just want to highlight because I know we've thrown a few terms around, and I'm certainly not a tax professional, but we're talking

1 about gross profit, correct?

2 A. That's correct.

3 Q. Okay. And obviously a different term that can
4 also be used is net profit, right?

5 A. Yes.

6 Q. Okay. And obviously net profit is much
7 different than your gross profit, correct?

8 A. Correct. Yes.

9 Q. And by virtue of the net, your net profit is
10 typically going to be lower than your gross profit,
11 right?

12 A. Correct.

13 Q. Okay. And in the testimony that was given by
14 Mr. Kennedy and the references that were made to, you
15 know, 32 or 35 percent were relative to net profit, not
16 gross profit, correct?

17 A. I do recall net profit, yes.

18 Q. Okay. And so that characterization -- because
19 obviously up here I'm just trying to clarify between the
20 two, you have talked about, you know, 80 percent, 70
21 percent, 60 percent, stuff like that. Obviously that
22 percentage of gross profit is different than net profit
23 that was referred to by Mr. Kennedy and claimed on the
24 tax returns, correct?

25 A. Yes.

1 Q. Okay.

2 MR. HARRINGTON: I don't have any other
3 questions, Judge.

4 THE COURT: All right.

5 MR. DAVIS: No questions. Thank you.

6 THE COURT: Okay. All right. You may step
7 down. Thank you, sir.

8 Anymore witnesses?

9 MR. DAVIS: No, your Honor.

10 MR. HARRINGTON: Nothing from the defense,
11 your Honor.

12 THE COURT: All right. I need to look at
13 tomorrow here.

14 My calendar is not functioning because it's
15 completely empty. It's not working.

16 THE CLERK: I can tell you what you have,
17 Judge.

18 You have a 10 o'clock motion hearing, an 11
19 o'clock discovery conference, a 1 o'clock plea and a 3
20 o'clock telephone conference.

21 THE COURT: 10, 11, 1 and 3?

22 THE CLERK: Uh-huh.

23 THE COURT: I need to look at it because some
24 of that is going to have to go away, obviously. I
25 thought tomorrow was, you know, maybe just one thing in

1 the morning. All right.

2 THE CLERK: The 10 and 11 are Micronics.

3 THE COURT: Yeah. What are the ones in the
4 afternoon?

5 THE CLERK: The 1 o'clock plea is counsel
6 coming from New York.

7 THE COURT: It's a plea?

8 THE CLERK: Uh-huh.

9 THE COURT: Okay. And what's at 3?

10 THE CLERK: It's a telephone conference in a
11 criminal case regarding a status conference.

12 THE COURT: Okay. 1 o'clock is a plea?

13 THE CLERK: Yes, Judge.

14 THE COURT: Let's go off the record.

15 (Bench trial adjourned at 3:40 p.m.)
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C E R T I F I C A T E

I, Susan M. Bateman, do hereby certify that the foregoing transcript is a true and accurate transcription of the within proceedings, to the best of my knowledge, skill, ability and belief.

Submitted: 4-8-20

/s/ Susan M. Bateman
SUSAN M. BATEMAN, RPR, CRR